

Department of the Treasury
Tennessee Consolidated Retirement System

For the Year Ended
June 30, 1999

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STATE OF TENNESSEE
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John G. Morgan
Comptroller

March 13, 2000

Members of the General Assembly
and
The Honorable Steve Adams, Treasurer
and
Members of the Board
Tennessee Consolidated Retirement System
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 1999. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/ks
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State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Tennessee Consolidated Retirement System
For the Year Ended June 30, 1999

AUDIT OBJECTIVES

The objectives of the audit were to consider the system's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

AUDIT FINDINGS

The audit report contains no findings.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
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Audit Report
Department of the Treasury
Tennessee Consolidated Retirement System
For the Year Ended June 30, 1999

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**Department of the Treasury
Tennessee Consolidated Retirement System
For the Year Ended June 30, 1999**

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee Consolidated Retirement System. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

LEGISLATIVE HISTORY

The Tennessee Consolidated Retirement System (TCRS) was established in 1972 by an act of the Tennessee General Assembly. Seven existing retirement systems were consolidated to provide retirement, disability, and death benefits to state employees, public school teachers, higher education employees, and employees of participating local governments. State laws govern the retirement plan, and amendments to the plan can only be made by legislation enacted by the General Assembly of the State of Tennessee.

An 18-member Board of Trustees has the responsibility to manage and oversee the operation of the consolidated system. The board consists of nine *ex officio* members from the executive, legislative, and judicial branches of state government, eight representatives of the active TCRS membership, and one representative of retirees. TCRS is administered by the Department of the Treasury under the legislative branch of state government. By state law, the State Treasurer serves as Chairman of the Board of Trustees and as custodian of the funds of the system.

Membership in the retirement system is a condition of employment for full-time state employees, K-12 teachers, higher education general employees, and employees of participating local governments. Membership is optional for part-time state employees and part-time employees of political subdivisions which have authorized such coverage. Interim teachers and part-time teachers have optional membership. Faculty and certain other employees of institutions of higher education may elect participation in either TCRS or an optional retirement program. TCRS

membership has grown steadily since 1972, when there were approximately 93,000 members. As of June 30, 1999, there were 188,080 active members and 71,646 retirees.

ORGANIZATION

The Tennessee Consolidated Retirement System is organized into three major service areas: Counseling Services, Financial Services, and Member Services.

Counseling Services is responsible for pre-retirement counseling of members on their potential benefit payments under different options. The section also processes claims for disability retirement and provides field support, including new employer coverage.

Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, and coordinates actuarial valuations.

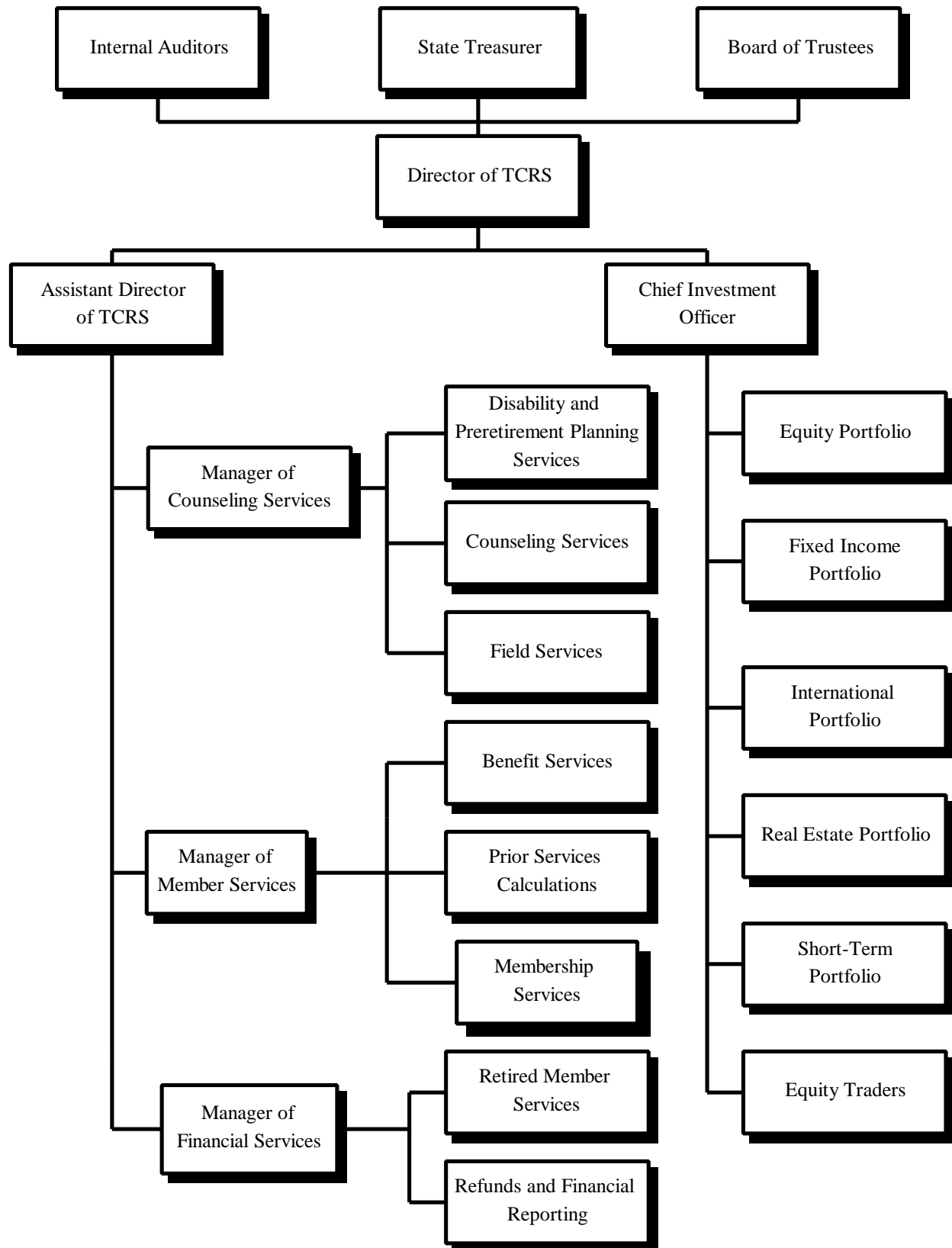
Member Services processes membership forms received from all state agencies, local boards of education, and participating political subdivisions. Prior service specialists assist in establishing prior service credit for eligible members or former members who have requested such credit. Benefit calculation specialists compute new retiree benefits based on the option chosen. The section is also responsible for researching, controlling, and correcting member records on the Treasury Retirement Accounting and Control System.

An organization chart for the Tennessee Consolidated Retirement System is on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 1998, through June 30, 1999, and was conducted in accordance with generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 1999, and for comparative purposes, the year ended June 30, 1998. The Tennessee Consolidated Retirement System forms an integral part of state government and as such has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
ORGANIZATION CHART**



OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Tennessee Consolidated Retirement System's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee Consolidated Retirement System's financial statements for the year ended June 30, 1999, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted government auditing standards. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Tennessee Consolidated Retirement System's financial statements.



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COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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**Report on Compliance and on Internal Control
Over Financial Reporting Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

December 10, 1999

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee Consolidated Retirement System as of and for the year ended June 30, 1999, and have issued our report thereon dated December 10, 1999. We conducted our audit in accordance with generally accepted government auditing standards.

Compliance

As part of obtaining reasonable assurance about whether the system's financial statements are free of material misstatement, we performed tests of the system's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

The Honorable John G. Morgan
December 10, 1999
Page Two

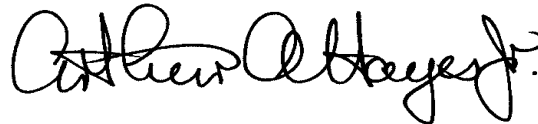
Internal Control Over Financial Reporting

In planning and performing our audit, we considered the system's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain matters involving the internal control over financial reporting, which we have reported to the system's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/ks



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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DIVISION OF STATE AUDIT
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Independent Auditor's Report

December 10, 1999

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System, as of June 30, 1999, and June 30, 1998, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated December 29, 1998, we qualified our opinion on the 1998 financial statements because insufficient audit evidence existed to support the Tennessee Consolidated Retirement System's disclosures required by Governmental Accounting Standards Board (GASB) Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*. The Tennessee Consolidated Retirement System's year 2000 disclosures are now reported as required supplementary information as permitted by GASB Technical Bulletin 99-1, *Disclosures about*

The Honorable John G. Morgan
December 10, 1999
Page Two

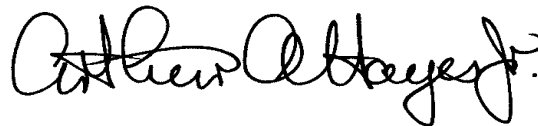
Year 2000 Issues—an amendment of Technical Bulletin 98-1. Accordingly, our present opinion on the 1998 financial statements, as expressed herein, is different from our prior report on the 1998 financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Consolidated Retirement System as of June 30, 1999, and June 30, 1998, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

The disclosure of year 2000 issues and the schedules of funding progress and employer contributions on pages 20 through 24 are not required parts of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and do not express an opinion on it. In addition, we do not provide assurance that the Tennessee Consolidated Retirement System is or will become year 2000 compliant, that the Tennessee Consolidated Retirement System's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Tennessee Consolidated Retirement System does business are or will become year 2000 compliant.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 10, 1999, on our consideration of the Tennessee Consolidated Retirement System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive script.

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/ks

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF PLAN NET ASSETS
AS OF JUNE 30, 1999, AND JUNE 30, 1998

Exhibit A

Expressed in Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 1999 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 1998 Total
ASSETS						
Cash	\$ 10,024	\$ 1,478	\$ 11,502	\$ 23,097	\$ 234	\$ 23,331
Receivables						
Member contributions receivable	13,467	2,911	16,378	12,681	2,596	15,277
Employer contributions receivable	20,131	5,230	25,361	13,491	4,899	18,390
Accrued interest receivable	159,933	23,581	183,514	140,343	20,395	160,738
Accrued dividends receivable	9,299	1,371	10,670	8,442	1,227	9,669
Other investment receivable	0	0	0	927	135	1,062
Investments sold	75,993	11,205	87,198	26,631	3,870	30,501
Total receivables	278,823	44,298	323,121	202,515	33,122	235,637
Investments, at fair value						
Short-term securities	638,904	94,204	733,108	802,397	116,608	919,005
Domestic securities						
Government bonds	7,139,133	1,052,638	8,191,771	6,426,129	933,874	7,360,003
Corporate bonds	2,601,061	383,516	2,984,577	2,697,109	391,956	3,089,065
Corporate stocks	6,308,927	930,227	7,239,154	5,655,385	821,866	6,477,251
International securities						
Government bonds	885,541	130,570	1,016,111	994,674	144,551	1,139,225
Corporate bonds	381,152	56,200	437,352	370,476	53,840	424,316
Corporate stocks	1,847,558	272,415	2,119,973	1,264,607	183,778	1,448,385
Total investments	19,802,276	2,919,770	22,722,046	18,210,777	2,646,473	20,857,250
TOTAL ASSETS	20,091,123	2,965,546	23,056,669	18,436,389	2,679,829	21,116,218
LIABILITIES						
Retired payroll payable	12,207	1,774	13,981	12,463	1,778	14,241
Warrants payable	599	533	1,132	408	298	706
Accounts payable						
Death benefits and refunds payable	851	655	1,506	789	428	1,217
Other	13	1	14	54	58	112
Investments purchased	206,994	30,520	237,514	35,760	5,197	40,957
Other investment payables	4,366	644	5,010	1,308	190	1,498
TOTAL LIABILITIES	225,030	34,127	259,157	50,782	7,949	58,731
NET ASSETS HELD IN TRUST FOR PENSION						
BENEFITS (Schedule of funding progress for the PSPP is presented on page 24)	\$ 19,866,093	\$ 2,931,419	\$ 22,797,512	\$ 18,385,607	\$ 2,671,880	\$ 21,057,487

See accompanying Notes to the Financial Statements.

TENNESSEE CONSOLIDATED RETIREMENT SYSTEM
COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 1999, AND JUNE 30, 1998

Exhibit B

Expressed in Thousands

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 1999 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)	For the Year Ended June 30, 1998 Total
ADDITIONS						
Contributions						
Member contributions	\$ 122,564	\$ 38,618	\$ 161,182	\$ 116,196	\$ 39,086	\$ 155,282
Employer contributions	244,453	69,230	313,683	166,756	65,276	232,032
Total contributions	367,017	107,848	474,865	282,952	104,362	387,314
Investment income						
Net appreciation in fair value						
of investments	883,577	129,430	1,013,007	1,655,047	239,084	1,894,131
Interest	705,107	103,288	808,395	655,178	94,644	749,822
Dividends	106,778	15,641	122,419	108,996	15,745	124,741
Total investment income	1,695,462	248,359	1,943,821	2,419,221	349,473	2,768,694
Less: Investment expense	9,682	1,423	11,105	9,332	1,350	10,682
Net income from investing activities	1,685,780	246,936	1,932,716	2,409,889	348,123	2,758,012
Securities lending activities						
Securities lending income	0	0	0	2,080	301	2,381
Less: Securities lending expense	0	0	0	1,857	268	2,125
Net income from securities lending activities	0	0	0	223	33	256
Net investment income	1,685,780	246,936	1,932,716	2,410,112	348,156	2,758,268
TOTAL ADDITIONS	2,052,797	354,784	2,407,581	2,693,064	452,518	3,145,582
DEDUCTIONS						
Annuity benefits						
Retirement benefits	414,149	60,182	474,331	378,485	53,991	432,476
Survivor benefits	25,934	3,769	29,703	24,127	3,441	27,568
Disability benefits	13,948	2,027	15,975	12,694	1,811	14,505
Cost of living	99,823	14,506	114,329	88,435	12,615	101,050
Death benefits	2,616	778	3,394	2,557	746	3,303
Refunds	13,491	12,143	25,634	14,311	10,338	24,649
Administrative expense	2,350	1,840	4,190	2,191	1,694	3,885
TOTAL DEDUCTIONS	572,311	95,245	667,556	522,800	84,636	607,436
NET INCREASE	1,480,486	259,539	1,740,025	2,170,264	367,882	2,538,146
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS						
BEGINNING OF YEAR	18,385,607	2,671,880	21,057,487	16,215,343	2,303,998	18,519,341
END OF YEAR	\$ 19,866,093	\$ 2,931,419	\$ 22,797,512	\$ 18,385,607	\$ 2,671,880	\$ 21,057,487

See accompanying Notes to the Financial Statements.

Tennessee Consolidated Retirement System
Notes to the Financial Statements
June 30, 1999, and June 30, 1998

The Tennessee Consolidated Retirement System (TCRS) administers two defined benefit pension plans - State Employees, Teachers and Higher Education Employees Pension Plan (SETHEEPP) and Political Subdivisions Pension Plan (PSPP). Although the assets of the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to members of that plan, in accordance with the terms of the plan.

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. **Reporting Entity** - The TCRS is included in the State of Tennessee Financial Reporting Entity. Because of the state's fiduciary responsibility, the TCRS has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.
2. **Measurement Focus and Basis of Accounting** - The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The TCRS follows all applicable GASB pronouncements, as well as applicable private sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the flow of economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Plan member contributions are recognized in the period in which the contributions are due. Plan employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

3. **Cash** - Cash and cash equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The state's accounting policy regarding the definition of cash and cash equivalents includes cash management pools as cash. In addition, under the policy, short-term securities otherwise defined as cash equivalents, that are in portfolios where the primary purpose is to facilitate the placement of funds in long-term investments, are classified as investments.

Cash received by the TCRS that cannot be invested immediately in securities is invested in the State Pooled Investment Fund administered by the State Treasurer. The State Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and Agency obligations, and in obligations of

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

the state of Tennessee pursuant to *Tennessee Code Annotated, Section 9-4-602(b)*. The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned to brokers for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The pool's custodial credit risk is presented in the *Tennessee Comprehensive Annual Financial Report* for the years ended June 30, 1999, and June 30, 1998. The classification of Cash also includes cash held in a custody account under a contractual arrangement for master custody services. Cash balances with the custodial agent are not classified into the credit risk categories established by Statement Number 3 of the Governmental Accounting Standards Board as the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

4. **Method Used to Value Investments** - Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Short-term investments that do not have an established market are reported at cost plus accrued interest, which approximates fair value. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.
5. **Receivables** - Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 1999, consist of \$33.6 million due from other funds within the state and \$8.1 million due from other governments. The receivables for contributions as of June 30, 1998, consist of \$26.2 million due from other funds within the state and \$7.5 million due from other governments.
6. **Reclassification** - Investments in the amount of \$208,047,651 that were classified as International Government Bonds on the June 30, 1998, Statement of Plan Net Assets have been reclassified as International Corporate Bonds.

B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION

At June 30, 1997, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	48,834	17,828
Terminated members entitled to but not receiving benefits	10,681	2,393
Current active members	<u>120,515</u>	<u>58,656</u>
Total	180,030	78,877
Number of participating employers	142	365

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

State Employees, Teachers and Higher Education Employees Pension Plan

Plan Description - SETHEEPP is a cost-sharing, multiple employer defined benefit pension plan that covers the employees of the state, teachers with Local Education Agencies (LEA's) and higher education employees. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan on or after July 1, 1979, are vested after five years of service. Members joining prior to July 1, 1979, are vested after four years of service. Compounded cost of living adjustments (COLA) are provided each July based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year except that (a) no COLA is granted if the CPI is less than one-half percent; (b) a COLA of one percent will be granted if the CPI increases between one-half percent and one percent; and (c) the maximum annual COLA is capped at three percent. Benefit provisions are established by state statute found in Title Eight, Chapters 34 through 37 of the *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly. Ad hoc increases may only be authorized by the General Assembly. Public safety officers receive an additional supplemental benefit that is paid from age 60 to age 62.

Superseded Systems and Certain Employment Classifications - Members of superseded systems that became members of the TCRS at consolidation in 1972, have their rights preserved to the benefits of the superseded system, if the benefit from the superseded plan exceeds that provided by the Group 1 (teachers and general employees) TCRS formula. Likewise, public safety employees and officials of TCRS Groups 2, 3 and 4 are entitled to the benefits of those formulas, if better than the Group 1 benefits.

Contributions and Reserves - Effective July 1, 1981, the plan became noncontributory for most state and higher education employees. The contribution rate for teachers is five percent of gross salary. The employers contribute a set percentage of their payrolls, determined by an actuarial valuation. *Tennessee Code Annotated* Title Eight, Chapter 37, provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state of Tennessee's annual budget process. Funding for the administrative budget is included in employer contributions.

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income, and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 1999, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$2,396.9 million and \$17,469.2 million, respectively. At June 30, 1998, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$2,268.7 million and \$16,116.9 million, respectively.

Political Subdivisions Pension Plan

Plan Description - PSPP is an agent multiple-employer defined benefit pension plan that covers the employees of participating political subdivisions of the state of Tennessee. Employee class differentiations are not made under PSPP. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979, are vested after four years of service. Members joining on or after July 1, 1979, are vested upon completion of 10 years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments (COLA) are the same as provided by SETHEEPP except that the local government may elect (a) to provide no COLA benefits or (b) to provide COLA benefits under a non-compounding basis rather than the compounded basis applicable under SETHEEPP. Benefit provisions are established and amended by state statute. Pursuant to Article Two, Section 24, of the *Constitution of the State of Tennessee*, the state cannot mandate costs on local governments. Any benefit improvement may be adopted by the governing body of a governmental entity participating in the TCRS.

Contributions and Reserves - Political subdivisions may elect contributory or noncontributory retirement for their employees. The contribution rate for contributory employees of political subdivisions is five percent of gross salary. The employers contribute a set percentage of their payrolls, equal to at least the percentage determined by an actuarial valuation. State statute provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state's annual budget process. Funding for the administrative budget is included in employer contributions.

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income, and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 1999, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$502.0 million and \$2,429.4 million, respectively. At June 30, 1998, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$467.6 million and \$2,204.3 million, respectively.

C. INVESTMENTS

State statute authorizes the TCRS to invest in bonds, debentures, preferred stock and common stock, real estate, and in other good and solvent securities subject to the approval of the Board of Trustees and further subject to the following restrictions:

- a. The total sum invested in common and preferred stocks shall not exceed seventy-five percent (75%) of the total of the funds of the retirement system.
- b. The total sum invested in notes and bonds or other fixed income securities exceeding one year in maturity shall not exceed seventy-five percent (75%) of the total funds of the retirement system. Private Placements are limited to 15% of the total fixed income portfolio.
- c. Within the restrictions in (a) and (b) above, an amount not to exceed fifteen percent (15%) of the total of the funds of the retirement system may be invested in securities of the same kinds, classes, and investment grades as those otherwise eligible for investment in various approved foreign countries.
- d. The total amount of securities loaned under a securities lending program cannot exceed thirty percent (30%) of total assets.
- e. The total sum invested in real estate shall not exceed five percent (5%) of the total of the funds of the retirement system.

The TCRS maintains a portfolio of short-term investments in order to actively manage all funds waiting to be placed in a more permanent investment. These short-term investments may include U.S. Treasury and Agency obligations, commercial paper, medium-term corporate notes, promissory notes, and repurchase agreements.

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

The TCRS investment securities are categorized on the chart that follows according to the level of custodial credit risk associated with the custodial arrangements. Category 1 includes investments that are insured or registered, or for which the securities are held by the TCRS or its agent in the name of the TCRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the TCRS. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the counterparty's trust department or agent, but not in the name of the TCRS.

Expressed in Thousands

	<u>Fair Value June 30, 1999</u>	<u>Fair Value June 30, 1998</u>
INVESTMENTS - CATEGORY 1		
Short-term securities		
Commercial paper	\$ 537,039	\$ 730,938
Medium-term corporate notes	0	31,584
U.S. government securities	196,069	156,483
Long-term investments		
Domestic securities		
Government bonds	8,024,874	7,354,911
Corporate bonds	2,931,825	3,089,065
Corporate stocks	7,222,722	6,465,187
International securities		
Government bonds	1,016,111	1,139,225
Corporate bonds	437,352	424,316
Corporate stocks	2,108,893	1,412,509
TOTAL INVESTMENTS - CATEGORY 1	<u>22,474,885</u>	<u>20,804,218</u>
INVESTMENTS - CATEGORY 2	<u>0</u>	<u>0</u>
INVESTMENTS - CATEGORY 3		
Margin deposit on futures contracts		
Domestic government bonds	<u>11,319</u>	<u>5,092</u>
INVESTMENTS - NOT CATEGORIZED		
Unsettled investment acquisitions		
Domestic securities		
Government bonds	155,578	0
Corporate bonds	52,752	0
Corporate stocks	16,432	12,064
International securities		
Corporate stocks	11,080	35,876
TOTAL INVESTMENTS - NOT CATEGORIZED	<u>235,842</u>	<u>47,940</u>
TOTAL INVESTMENTS	<u>\$ 22,722,046</u>	<u>\$ 20,857,250</u>

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

As of June 30, 1999, and June 30, 1998, the TCRS had no concentrations of investments, other than those issued or guaranteed by the U.S. government, in any one organization that represents five percent or more of plan net assets.

Securities Lending - The TCRS is authorized by its investment policy, as adopted by the Board of Trustees, to enter into collateralized securities lending agreements whereby the TCRS loans its debt and equity securities for a fee to a select few of the highest quality securities firms and banks. Loans must be limited so the total amount on loan does not exceed 30 percent of the TCRS' assets. The TCRS' custodian bank manages the lending program and maintains the collateral on behalf of the TCRS. The borrower may deliver collateral to the lending agent in the form of cash or bonds, notes, and treasury bills of the United States or other obligations guaranteed as to principal and interest by the United States or any of its agencies or by the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Student Loan Marketing Association, and other United States government sponsored corporations or enterprises. Cash received as collateral may be reinvested by the lending agent in accordance with the investment policy, as further restricted under the TCRS securities lending agreement. Collateral securities cannot be pledged or sold unless the borrower defaults.

The loaned securities are initially collateralized at 102 percent of their fair value for domestic securities and 105 percent for international. Collateral is marked-to-market daily and additional collateral is pledged by the borrower if the fair value of the collateral subsequently falls below 100 percent for domestic securities and 105 percent for international. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the securities on loan can be terminated on demand by either the TCRS or the borrower. For the fiscal year ending June 30, 1999, the TCRS had no securities on loan. As of June 30, 1998, the TCRS had no securities on loan. The TCRS securities lending income, net of expenses, was \$255,741 for the year ended June 30, 1998.

Financial Instruments with Off-Balance Sheet Risk

The TCRS is a party to financial instruments with off-balance sheet risk used in the normal course of business to generate earnings and reduce its own exposure to fluctuations in market conditions. The TCRS is authorized by state statute to engage in forward contracts to exchange different currencies at a specified future date and rate and in domestic stock index futures contracts. These contracts involve elements of custodial credit, market, and legal risk in excess of amounts recognized in the Statements of Plan Net Assets as of June 30, 1999, and June 30, 1998. The TCRS may purchase or sell domestic stock index futures contracts for the purposes of making asset allocation changes and improving liquidity. Futures contracts are limited to the S&P 500 Index, the S&P Midcap 400 Index, and the Russell 2000 Index. The contractual or notional amounts express the extent of the TCRS' involvement in these instruments and do not represent exposure to credit loss. The credit risk on forward and futures contracts is controlled

Tennessee Consolidated Retirement System
Notes to the Financial Statements (Cont.)
June 30, 1999, and June 30, 1998

through limits and monitoring procedures. Market risk, the risk that changing market conditions may make a financial instrument less valuable, is controlled through limitations on the use of such instruments. Legal risk is controlled through the use of only authorized instruments and brokers. The allowable currencies for hedging purposes are limited by policy of the Board of Trustees to the currencies of those countries otherwise authorized for investment.

At June 30, 1999, there were forward exchange contracts outstanding at a total net notional amount of \$589,694,318 and a fair value of \$569,519,506. At June 30, 1998, there were forward exchange contracts outstanding at a total net notional amount of \$528,898,678 and a fair value of \$524,041,284.

At June 30, 1999, the notional amount of futures contracts was \$165,256,250 at a fair value of \$172,712,500. At June 30, 1998, the notional amount of futures contracts was \$138,731,250 at a fair value of \$142,875,000. The changes in fair value of outstanding futures contracts are settled daily.

The TCRS is also authorized by investment policy to engage in the issuance of options. Activity is limited to selling covered call options. The TCRS had no options outstanding at June 30, 1999 and June 30, 1998.

Asset-Backed Securities

The TCRS invests in collateralized mortgage obligations (CMOs) which are mortgage-backed securities. These securities are based on cash flows from interest and principal payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. The CMOs held were issued by quasi-U.S. governmental agencies. The fair value of these securities was \$65,145,109 at June 30, 1999, and \$110,059,380 at June 30, 1998. The TCRS also invests in various asset-backed securities, representing ownership interests in trusts consisting of credit card or auto loan receivables. These securities are issued by organizations with AAA or AA credit ratings. TCRS invests in these securities primarily to enhance returns by taking advantage of opportunities available in this sector of the securities markets.

D. COMMITMENTS

Standby Note Purchase Agreement - The TCRS has agreed to serve as standby note purchaser for notes issued by the Funding Board of the State of Tennessee. By serving as a standby note purchaser, the TCRS receives an annual fee of 7.5 basis points on the \$250 million maximum issuance under this agreement. In the unlikely event that the TCRS would be called upon to purchase the notes, the TCRS would receive interest at a rate equal to prime plus 75 basis points. Moody's Investors Services, Inc., and Standard and Poor's have given these notes of the Funding Board ratings of M1G1/VM1G1 and SP-1+/A-1+, respectively.

Tennessee Consolidated Retirement System

Required Supplementary Information

YEAR 2000 DISCLOSURES

The TCRS is currently addressing the “Year 2000” (Y2K) issue relating to computer systems and other electronic equipment. The Y2K issue refers to the fact that many computer software programs use only the last two digits of a data field to refer to “year” on the assumption that the first two digits are “19.” These programs would interpret the year 2000 as the year 1900, the year 2001 as 1901, etc. The issue therefore extends to computer hardware, electronics, and other equipment dependent on microchip technology. In addition, some computer programs may not recognize that the year 2000 is a leap year, resulting in incorrect date calculations. Without reprogramming, such software and equipment could impact the ability to input data into computer programs and the ability of such programs to correctly process data. Y2K affects the computer systems utilized directly by the TCRS as well as the other systems upon which the TCRS depends to fulfill its mission. The TCRS’ Y2K initiatives relating to the retirement system did not result in the commitment of significant financial resources as of June 30, 1999, and June 30, 1998.

The TCRS has assessed the impact of Y2K on its computer systems and has determined that certain computer systems are mission-critical, certain are critical, and certain are supportive. Mission-critical computer systems are those for which there are no reliable manual alternatives, and for which failure to be in Y2K compliance would prevent the TCRS from fulfilling its mission. Critical computer systems are those for which there are manual alternatives, but the TCRS would be unlikely to be able to fully or efficiently perform the functions manually, because of the volume of manual activity that would be required. Supportive computer systems are those for which there are manual alternatives that could be performed if necessary.

The TCRS relies upon three major computer systems to manage the responsibilities of the retirement program. The retired payroll system generates monthly annuity payments to more than 70,000 retirees each month. The active membership system maintains the data of more than 200,000 active and inactive member records. This system is utilized to record employee and employer contributions; to record service and salary credit for each member; to process lump sum refunds to terminating members; to maintain records of each employer participating in the retirement plan; to maintain member data including beneficiary, date of birth, etc.; to provide annual statements to members; to invoice members for the purchase of service credit; and to provide benefit estimates. The third major system is the investment system which maintains a perpetual inventory of all the securities owned by TCRS. The investment system maintains a record of all the acquisitions, dispositions, and maturities of securities in the TCRS portfolio and initiates settlement with the TCRS investment custodian. Other important but less significant systems include the document inventory system and the general ledger accounting system. The document inventory system is utilized to maintain a record of the incoming and outgoing documents and correspondence. The general ledger accounting system is utilized to reconcile the subsidiary ledgers and to produce financial statements.

Tennessee Consolidated Retirement System

Required Supplementary Information (Cont.)

TCRS has identified the above mentioned computer systems that are mission-critical and has subjected those systems to the following stages of work to address year 2000 issues.

Awareness stage - Establishing a budget and project plan for dealing with the year 2000 issue.

Assessment stage - Identifying the systems and components for which the year 2000 compliant work is needed.

Remediation stage - Making changes to systems and equipment.

Validation/testing stage - Validating and testing the changes that were made during the remediation stage.

TCRS' year 2000 remediation work for its mission-critical systems and electronic equipment are in the following stages of work. "C" means complete and "P" means in progress. While the completion of such stages is an indication of progress made in addressing the Y2K issue, it is not a guarantee that the systems and equipment will be year 2000 compliant.

	Awareness	Assessment	Remediation	Validation/Testing
Retired Payroll System	C	C	C	C
Active Membership System	C	C	C	C
Investment System	C	C	C	C
Document Inventory System	C	C	C	C
Accounting System	C	C	C	C
Electronic Equipment	C	C	P	P

The TCRS has contacted external organizations with a mission-critical relationship whose year 2000 compliance could affect the operations of the retirement system. Such organizations have responded that they are year 2000 compliant or expect to achieve compliance prior to January 1, 2000. Other organizations with less critical relationships have been contacted to remind them of the potential problems surrounding the year 2000 and the need to evaluate their systems.

Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Management cannot assure that TCRS is or will be year 2000 ready, that the TCRS' remediation efforts will be successful in whole or in part, or that parties with whom TCRS does business will be year 2000 ready.

Tennessee Consolidated Retirement System

Required Supplementary Information (Cont.)

Schedule of Funding Progress

SETHEEPP

For budgetary purposes, the cost of funding the pension obligations of the state employees, teachers, and higher education employees pension plan (SETHEEPP) is determined separately as follows:

- (1) General state employees and higher education employees
- (2) Teachers (grades K-12)
- (3) State Judges employed after June 30, 1972
- (4) Attorneys General employed after June 30, 1972
- (5) State Judges and Attorneys General employed prior to July 1, 1972
- (6) County Officials employed prior to July 1, 1972

All the groups above, except the County Officials group and the State Judges and Attorneys General group employed prior to July 1, 1972, are funded under the aggregate actuarial cost method. The frozen entry age actuarial method is utilized for these two groups not under the aggregate actuarial cost method. The aggregate actuarial cost method does not identify or separately amortize unfunded actuarial liabilities. The SETHEEPP groups funded under the aggregate method would not have an unfunded actuarial liability under the frozen entry age actuarial method.

In accordance with GASB 25, a schedule of funding progress is not presented since more than 98% of the liabilities are determined under the aggregate actuarial funding method.

PSPP

The political subdivision pension plan (PSPP) represents 365 participating entities at June 30, 1997, some of which are funded under the aggregate actuarial cost method and others under the frozen entry age actuarial method. The following data represents only those political subdivisions where the frozen entry age actuarial method is utilized.

Expressed in Thousands

Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued Liability (AAL) Frozen Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
6/30/97	\$1,020,240	\$1,078,231	\$57,991	94.62%	\$583,294	9.94%

Tennessee Consolidated Retirement System Required Supplementary Information (Cont.)

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 1999. There are 168 of the 365 political subdivisions in TCRS as of the June 30, 1997, actuarial valuation, with an unfunded actuarial accrued liability. Information according to the parameters for measuring pension expenditures, expense, and related actuarially determined disclosure information, as required by GASB, is available beginning with the transition year.

See accompanying Notes to Required Supplementary Information.

SCHEDULES OF EMPLOYER CONTRIBUTIONS

Expressed in Thousands

Year Ended June 30	SETHEEPP		PSPP	
	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
1999	\$244,453	100%	\$69,230	100%
1998	\$166,756	100%		

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 1999. The June 30, 1995, valuation determined the employer contribution rate for the year ended June 30, 1997, for the SETHEEPP and the PSPP, and for the year ended June 30, 1998, for the PSPP. Therefore, the Schedule of Employer Contributions, in accordance with the parameters of GASB Statement Number 25, is not available for the year ended June 30, 1997, for either plan or for the year ended June 30, 1998, for the PSPP.

See accompanying Notes to Required Supplementary Information.

Tennessee Consolidated Retirement System
Notes to the Required Supplementary Information

The information presented in the required supplementary Schedule of Funding Progress was determined as part of the latest actuarial valuations as of June 30, 1997. Additional information follows.

	<u>SETHEPP</u>	<u>PSPP</u>
Valuation Date	6/30/97	6/30/97
Actuarial cost method	Aggregate (1)	(2)
Amortization method	Level Dollar (3)	Level Dollar (3)
Remaining amortization period	18 years (3) closed period (3)	(4) closed period
Asset valuation method	5-year Moving Market Average	5-year Moving Market Average
Actuarial assumptions:		
Investment rate of return	7.5%	7.5%
Projected salary increases	5.5%	5.5%
Includes inflation at	(5)	(5)
Cost-of-living adjustments	3%	3%
Increase in Social Security wage base	4.5%	4.5%
(1)	The frozen entry age actuarial method is utilized for two small closed groups: county officials employed prior to July 1, 1972, and a group of state judges and attorneys general employed prior to July 1, 1972.	
(2)	Some political subdivisions are funded under the aggregate actuarial funding method and some under the frozen entry age actuarial method.	
(3)	Applies to groups funded under the frozen entry age actuarial method.	
(4)	The length of the amortization period varies by political subdivision but does not exceed 20 years.	
(5)	No explicit assumption is made regarding the portion attributable to the effect of inflation on salaries.	